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London's 'Big Grab' Could Spell Dollar Panic

Wall Street is debating a scenario: what if the capital-account flows of petrodollars back into the U.S. economy — the main prop of the dollar's international value since the rise in oil prices — were to be diverted instead to London?

Standard wisdom, from economists like Merrill Lynch's Eugene Sherman, is that the torrential flows of Arab money into long-term U.S. investments have built up an Arab interest in U.S. market stability that rules out any panicky move out of dollar paper. But the available evidence shows that the New York financial community is indulging in a level of complacency that might turn out to be suicidal. London is making the big grab, and the United States has done nothing effective to stop it.

A handful of press comments last week reflect extreme concern over what is afoot. On Oct. 21, the *Christian Science Monitor* reported on its front page that the Administration is sending out "frantic signals" to the Arabs that it will take steps to prevent further depreciation of the dollar, in order to preempt further sell-off of dollars in the foreign exchange market. Before Treasury Secretary Blumenthal's apparent turnabout on the usefulness of a depreciating dollar Oct. 19, flight of petrodollars had accounted for a major portion of pressure against the U.S. currency.

If the dollar continues to depreciate — and the side-effect of rising interest rates destabilizes dollar securities markets — then the Arabs will have major disincentives against further investments in U.S. paper, and a panic could take off. This scenario is standard wisdom at the leading London merchant banks, the Executive Intelligence Review earlier reported, and has been described to this service by officers of Schroder Wagg, A.S. Bleichroeder, and other City of London houses.

"What's Good for Britain..."

One U.S.-based observer who supports this scenario is Columbia University Professor Robert Mundell, organizer of the yearly conference on international monetary affairs at Villa Santa Colomba under the sponsorship of the Monte dei Paschi bank in Sienna. "Someone should get the Arabs to stop lending to the United States," Mundell said in an interview. "If there is an outflow of money, that would improve the U.S. deficit," because the United States would no longer be able to finance the same volume of imports through capital re-flows. Mundell explained that the U.S. economy could adjust to the shock, "because the money would flow to Britain, and Britain would lend it to us. Then sterling would take some of the exchange risk" of holding Arab funds, "and Britain would hold claims against the U.S. instead of the Arabs."

"Britain has been weak for too long," the Canadian-born economist said, "and that is bad for the world economy. What's good for Britain is good for the world." The political impact of Britain's reemergence as a world financial power would also be desirable, Mundell believes. "Those countries in Europe that have monarchies have, by and large, had the best governments. They haven't been especially aggressive, and they have tended to be proponents of human rights and world order."

Is Mundell, who quips that "only 10 percent of the people listen to me," merely representing an extreme view? Almost certainly not. His Sienna conference last summer was the launching-pad for the "Common European currency," or "Europa," plan which Britain's Roy Jenkins has made the central policy objective in his capacity as Chairman of the European Commission. One European central bank governor told this reporter, "The Jenkins plan is a plot to have a European currency which the City of London could sit on and control Europe." Mundell adds, "London is the most likely center of the European financial community."

Another leading economist who warns of capital flight to London is Princeton's Peter Kenen. If the current-account deficit begins to affect the capital account, Kenen says, "the situation could very easily get out of control." Another factor cited by Kenen is the push by congressional liberals to limit arms sales to the Mideast. "If we cut back on armaments contracts to the Middle East, which Congress seems to want, then the Arabs will have even less incentive to invest in dollars. Arab placements of dollars are a kind of prepayment for future purchases of American exports," Kenen believes.

London's financial press is churning out copy to the same effect. In the Oct. 20 *Financial Times*, columnist Samuel Brittan argues in a long op-ed that the American monetary authorities are not in control of the money supply and inflation, boding ill for the dollar's value abroad. Brittan argues for an across-the-board 5 percent devaluation of the dollar, for starters. Afterwards, Brittan writes, "private investors and OPEC countries could decide whether they wish to invest in the U.S. at a level which more accurately reflects the authorities' ability to control inflation." Interviewed in last week's *Investor's Chronicle*, a weekly owned by the *Financial*

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Times, Schroder's Geoffrey Bell reports a huge increase in the volume of funds under London merchant bank management. After 1974, Bell reported, the merchant banks introduced Reserve Asset Management Plans to handle surplus funds of OPEC central institutions, U.S. and European multinational corporations, and, later, the commercial banks themselves. The London merchant banks and some of the U.S. investment groups like Brown Bros. Harriman and Merril Lynch were best-placed to manage the flood of free liquidity, Bell explained. (Privately, Hambros Ltd. estimate the volume of funds under such management at about $5 billion a year.)

How can Britain, whose industrial output remains at 1970 levels despite the paper-recovery of its foreign exchange reserves and financial markets, expect to compete with the huge U.S. capital market, backed by the strongest economy in the world? London's argument is that since there are now as many dollars abroad as in the U.S. money supply, the dollar is out of control of the U.S. monetary authorities. For this reason, says *International Currency Review*, a London bi-monthly, "a really catastrophic run on the dollar" is entirely possible. A commentator in last week's *Money Manager* adds, "The control of the American money market now lies in the free forces of the City of London, and not the U.S. monetary authorities."

Truth About the Consequences

Even a very small diversion of petrodollar flows into the United States on capital account would have devastating consequences for the dollar. Since 1974, at least half of the OPEC surplus has flown back to the United States, and half of this has gone into nongovernmental long-term private investment. This is the conclusion of one internationally-oriented New York investment bank. Overall, according to this estimate, the net rise of foreign assets in the U.S. reported in the capital account of balance of payments has risen, on average, by 35 billion per annum, or by about the same amount as the OPEC surplus. Foreign private investment has been roughly half of this:

Non-government investment in U.S. private sector

Year	Amount
1974	$27 billion
1975	$ 5 billion
1976	$16 billion
1977	$ 8 billion*

*projection of first half

Source: U.S. Dept. of Commerce

The fluctuations in private-sector investment tend to correspond to compensating changes in foreign official investments, bringing the annual total to an average $35 billion.

This includes both direct OPEC investments and petrodollars recycled through mainly continental European banks and central banks, according to the cited Wall Street analysis. Only this year, with the $12 billion net inflow into London, has the City gotten a piece of the action. Any disruption of these flows would devastate the dollar.

The British are currently making their play in the Mideast. Granted, the Arab stake in U.S. stability in the U.S. is commensurately great. But if the Administration continues to tolerate dollar-dumper Michael Blumenthal, and publicly advertise its intention to unseat dollar-defender Arthur Burns, the dollar will go out of control in the very short run.

—David Goldman

A New Stage In The Dollar Fight

FOREIGN EXCHANGE

The unusual public message from the White House to the Federal Reserve on Oct. 20, warning further substantial increases in short-term interest rates could damage the progress of the U.S. "recovery," marked a new state in the fight over U.S. monetary policy and the fate of the dollar. While industry-oriented regional Federal Reserve presidents, certain U.S. business leaders, and European and Japanese central bankers have been lobbying for a strong dollar policy against inflation, the "toilet paper dollar" faction has regrouped for a new assault against the U.S. currency.

Echoing the views of the Democratic Party majority of the Joint Economic Committee of Congress, the White House statement took the Federal Reserve to task for unwarranted concern over the rapid growth of the U.S. money supply. In its efforts to curb money supply growth, the statement argued, the Fed has pushed up short-term interest rates about 2 percent since last spring, endangering the mortgage markets and the whole economy.

The White House statement coincided with renewed discussion over whether current Federal Reserve chairman Arthur Burns will be retained by President Carter when his present term expires next Jan. 31. One well-placed source indicated Oct. 21 that the man British-oriented, U.S. Fabian circles have in mind for the post is Bruce McLaury, the former president of the Federal Reserve Bank of Minneapolis. McLaury is also a member of David Rockefeller's Trilateral Commission and president of the Brookings Institution. In addition to McLaury's ideological qualifications, there are technical reasons in his favor. With the Atlantic seaboard already fully represented on the Board of Governors, any new appointee must come from one of the other Fed districts.